

15 May 2017

## Circular to Financial Advisers in relation to their Advisory Work on Valuations in Corporate Transactions

### Introduction

1. The Securities and Futures Commission (**SFC**) today issued a guidance note on directors' duties in the context of valuations in corporate transactions involving listed companies (**Guidance Note**). Under the Guidance Note, among other things:
  - directors should consider the need for a valuation by a professional valuer of an asset or a target company which the company is proposing to acquire or dispose of;
  - the scope of the valuer's mandate should be appropriately drafted to ensure that the valuation report will be relevant and useful in aiding the directors to determine the fair and reasonable offer price for the asset or target company and the directors can reasonably rely on the valuation;
  - directors should take all reasonable steps to verify the accuracy and reasonableness of material information that is likely to affect the valuation of the asset/target company, including financial forecasts, business plans and assumptions;
  - directors should provide a valuer with all relevant information that is likely to affect the valuation as part of the instructions to the valuer;
  - directors' reliance on a valuation must be reasonable in all the circumstances; and
  - directors should draft, in consultation with a financial adviser appointed in a transaction under the Listing Rules<sup>1</sup>, the scope of the financial adviser's mandate appropriately for the matter in hand.

### Background

2. Based on industry practice, different valuation methodologies, such as discounted cash flows model, market comparable companies and precedent transactions, may be used in the context of valuations in corporate transactions. The choice of valuation methodology is key for pricing an asset or a target company given that particular methodologies might only be appropriate for specific circumstances, and when wrongly applied, they could yield unreasonable results.
3. Listing Rule 14.62(3) states that where an announcement contains a profit forecast, and a financial adviser has been appointed in connection with the transaction, the listed company must submit a report from the financial adviser confirming that the financial adviser is satisfied that the forecast has been made by the directors after due and careful enquiry. Under Listing Rule 14.61, profit forecasts include any valuation of

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<sup>1</sup> Rules Governing the Listing of Securities on the Stock Exchange and the GEM Listing Rules (**Listing Rules**).



assets (except for property interests (as defined in the Listing Rules)) or businesses acquired by a listed company based on discounted cash flows or projections of profits, earnings or cash flows.

4. The prevailing industry practice is for the relevant mandates to be drafted so that the scope of the financial advisers' work is confined only to providing the required confirmation under Listing Rule 14.62(3).
5. However, financial advisers typically do not provide an opinion on the reasonableness of the valuation methods or the bases and assumptions adopted, stating explicitly that the directors and the valuers (if appointed) are solely responsible for these aspects.
6. A financial adviser<sup>2</sup> is required under the CFA Code to:
  - (a) act with due skill, care and diligence and observe proper standards of market conduct (paragraph 5.1);
  - (b) when relying on the work of independent experts or other professionals (paragraph 5.3), inter alia:
    - undertake reasonableness checks to assess the relevant experience and expertise of the firm of experts or other professionals and to satisfy itself that reliance could fairly be placed on their work; and
    - review and discuss with its clients and the experts or other professionals the qualifications, bases and assumptions adopted by the experts or the other professionals in the course of their work and satisfy itself that the qualifications, bases and assumptions have been made with due care and objectivity, and on a reasonable basis<sup>3</sup>;
  - (c) where information and representations are provided by a client for incorporation in a public document or submission to the Regulators, advise its client to take all reasonable steps to ensure, and obtain confirmation from the client, that the information and representations provided are true, accurate, complete and not misleading, and that no material information or facts have been omitted or withheld (paragraph 5.5);
  - (d) use all reasonable efforts to ensure that its client understands the relevant regulatory requirements and their implications at all stages of a transaction. Upon becoming aware that its client is not complying with the regulatory requirements, it should advise its client to bring the matter to the attention of the regulators at the earliest opportunity. If this is declined by the client without valid reasons, it should consider the need to cease to act (paragraph 6.3); and
  - (e) take all reasonable steps to give its client, in a comprehensive and timely manner, any information required (including advice on the Listing Rules) to enable its client to make a balanced and informed decision (paragraph 6.4 (b)).

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<sup>2</sup> A financial adviser is a Corporate Finance Adviser as defined under the Corporate Finance Adviser Code of Conduct (**CFA Code**).

<sup>3</sup> This requirement is not applicable to work performed by: (i) a property valuer in respect of a valuation of real property if it is a member of a relevant regulatory or professional body; (ii) legal advisers in respect of legal advice rendered by them; and (iii) accountants in respect of the audit results and accountants' reports derived therefrom.



## **Mandate of Financial Advisers in Valuations in Corporate Transactions under the Guidance Note**

7. Under the Guidance Note, where the listed company appoints a financial adviser in respect of a particular corporate transaction, directors should, in consultation with the financial adviser, draft the scope of the mandate of the financial adviser appropriately for the matter at hand. This includes ensuring that the scope of the mandate is sufficient to enable the financial adviser to discharge its obligations and to comply with the requirements set out in the CFA Code, as appropriate. In cases where the transaction involves valuation by a valuer, the scope of the mandate of the financial adviser should specifically ensure that the financial adviser will be able to discharge its obligations under and comply with paragraph 5.3(a) and where applicable, 5.3(b), of the CFA Code.

### **Guidance to Financial Advisers**

8. Financial advisers are reminded to comply with all applicable requirements in the CFA Code where they have been appointed to advise on valuations in corporate transactions.
9. Financial advisers should not rely solely on representations made by the directors, their delegates or other third parties. Financial advisers should conduct their own assessment and undertake reasonableness checks as appropriate on the forecasts, assumptions, qualifications and methodologies of the valuation and the directors' decision on whether or not to appoint a professional valuer. In certain circumstances, it may be appropriate for several valuation methodologies to be utilised in arriving at the final valuation result. In the event that a financial forecast appears unduly optimistic, financial advisers should bring this to the attention of the directors for consideration and appropriate action.
10. In cases where the directors have decided to appoint a valuer for the purpose of issuing a valuation report, financial advisers should be satisfied that the directors have, inter alia:
  - (a) appointed the valuer after due consideration of that valuer's independence, reputation, qualification, relevant experience and available resources;
  - (b) set an appropriate scope of the valuer's mandate, taking into account the opinion required to be given and whether any qualifications in scope would adversely impact on the reliability of the valuation report;
  - (c) critically reviewed the reasonableness of the financial forecasts<sup>4</sup>, together with the valuation methodologies, assumptions and qualifications on which the valuation has been based; and
  - (d) made due inquiries when any of the valuation methodologies, financial forecasts, assumptions and qualifications appeared unreasonable and accepted the valuation only after all issues had been satisfactorily resolved.

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<sup>4</sup> These financial forecasts may be prepared by the listed company or by any other person, which can be the vendor of the proposed asset or the management of the target company which is the subject of the proposed investment or any of their respective related parties.



11. Having regard to paragraph 15 of the Guidance Note and paragraph 5.5 of the CFA Code, in cases where the directors have decided not to appoint a valuer, financial advisers should advise the directors on the appropriateness of not appointing a valuer. In particular, financial advisers should be satisfied that:
- (a) the directors' decision not to appoint a valuer is reasonable on the premise that, inter alia:
    - (i) the directors possess sufficient experience or expertise in the field of the proposed investment (i.e. being the asset or target company which the company is proposing to acquire or dispose of) as well as in forecasting profit and valuation;
    - (ii) the proposed investment or the information provided in respect of the proposed investment does not require professional advice or professional scrutiny in order to properly assess the merits of the investment; and
    - (iii) the decision is reasonable given the materiality of the proposed investment to the listed company, the risks involved and the complexity or nature of the proposed investment;
  - (b) where the directors have relied on a financial forecast or valuation prepared by any person (professional or otherwise) other than a valuer, such reliance is reasonable on the premise that they have taken steps equivalent to those in paragraphs 10 and 11(a) above, as appropriate; and
  - (c) where they have made their own financial forecast or valuation, the directors can, inter alia, reasonably explain the assumptions, methodology, source and reliability of the financial forecast or valuation.
12. Lastly, if financial advisers cannot be satisfied that the valuation methodology is reasonable and that the valuation has been made by the directors after due and careful enquiry, they should use all reasonable efforts to ensure that the directors understand the relevant regulatory requirements (including the Guidance Note) and their implications and provide advice. Depending on the circumstances, financial advisers might also need to consider the need to cease to act for the directors concerned.

Should you have any queries regarding this circular, please contact Ms Seine Luk at 2231 1696.

Intermediaries Supervision Department  
Intermediaries Division  
Securities and Futures Commission

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